



Board of Retirement Regular Meeting

Sacramento County Employees' Retirement System

Agenda Item 18

MEETING DATE: September 15, 2021

SUBJECT: Asset Class Restructuring: Private Credit

SUBMITTED FOR: ___ Consent X Deliberation and Action ___ Receive and File

RECOMMENDATION

Staff recommends the Board approve the proposed implementation plan and revisions to the structure of the Private Credit asset class as presented by Cliffwater and SCERS' Investment Staff. The specific recommendations include:

- Establish range of +/- 2% around the new 5% target allocation (3% - 7%).
- Rename the 'Opportunistic Credit' sub-strategy to 'Opportunistic Lending'.
- Adopt new strategy and geographic allocation targets and ranges as identified in the implementation plan.
- Maintain the 2021 Private Credit investment plan until the Board approves an updated commitment pacing budget in early 2022.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

PURPOSE

This item supports the implementation of the revised strategic asset allocation, which calls for Staff and consultants to identify structuring considerations and implementation plans for each major asset class.

PRIVATE CREDIT STRATEGIC CHANGES

SCERS' Board approved a revised strategic asset allocation for SCERS in August 2021, which resulted in the Private Credit target allocation increasing from 4% to 5%. The current allocation to Private Credit is 2.0% as of June 30, 2021. Private market valuations are lagged a quarter. Private Credit was added as a dedicated asset class in 2017 at a 4% target allocation, and the current allocation of 2.0% is on pace toward the multi-year build up of the asset class toward its target allocation.

The 'Implementation Plan' section for Private Credit below will cover the plan to build the Private Credit allocation toward the new target allocation of 5%.

The Private Credit asset class resides within the Growth asset category, and the asset class target allocations are shown below:

| Asset Class | Prior Target Allocation | Revised Target Allocation | Actual Allocation |
|------------------------------|-------------------------|---------------------------|-------------------|
| Growth Asset Category | 58.0% | 58.0% | |
| Global Equity | 40.0% | 40.0% | |
| Private Equity | 9.0% | 11.0% | |
| Public Credit | 2.0% | 2.0% | |
| Private Credit | 4.0% | 5.0% | 1.7% |
| Growth Absolute Return | 3.0% | 0.0% | |

RECOMMENDED PRIVATE CREDIT STRUCTURE REVISIONS

Recommendations related to the structure of SCERS’ Private Credit asset class are shown below. The recommended changes will go into effect upon Board approval; however, they will not be reflected in the investment policy statement until a later date. Private Credit resides within a broader Growth asset category IPS, along with Public Equities, Public Credit, Private Equity, and Growth Absolute Return. Staff will present a revised Growth asset category IPS at a later date, incorporating the proposed revisions to the Private Credit asset class, as well as the other Growth asset classes, once they are all approved by the Board. The Master IPS will also be updated accordingly.

Private Credit Target and Range:

The prior Private Credit target allocation had a range of +/- 2% around the 4% target as shown below:

| Private Credit | Prior Target % | Current Range |
|----------------|----------------|---------------|
| | 4% | 2% - 6% |

Staff and Cliffwater recommend maintaining the Private Credit range at +/- 2% around the new 5% target allocation, as show below.

| Private Credit | New Target % | Recommended Range |
|----------------|--------------|-------------------|
| | 5% | 3% - 7% |

Private Credit Sub-Strategy Renaming:

The Private Credit asset class is comprised of two sub-strategies, Direct Lending and Opportunistic Credit. Staff and Cliffwater recommend renaming the ‘Opportunistic Credit’ sub-

strategy to 'Opportunistic Lending', which is a more accurate description and is intended to limit confusion with other credit-based strategies within SCERS' portfolio. Opportunistic Lending investments are performing loans like those in Direct Lending (not distressed), but represent a broader range of investment types (mostly senior secured structures, but can also include subordinated debt structures, convertible debt, and structured equity). Opportunistic Lending can also lend against specific assets and can have meaningful equity participation, depending on the structure, but it is still a lending based strategy.

Private Credit Sub-Strategy Diversification Guidelines:

Staff and Cliffwater recommend adjusting the strategy and geographic allocation targets and ranges for Private Credit as show below. The mix between Direct Lending and Opportunistic Lending changes from a 70%/30% split to a 65%/35% split, with both sub-strategies maintaining fairly flexible ranges. The adjustment is driven by the evolution of the private credit market, where Cliffwater and Staff are finding a greater number of interesting strategies within the Opportunistic Lending space to complement the Direct Lending sub-strategy. The latter will still comprise the bulk of the investments within Private Credit.

Staff and Cliffwater also recommend adjusting the geographic mix between the U.S. and non-U.S. markets from 85%/15% to 75%/25%. Similar to above, the adjustment is driven by the evolution of the private credit market, where Cliffwater and Staff are finding a greater number of interesting non-U.S. strategies to complement those within the U.S. market. The latter will still comprise the bulk of the investments within Private Credit.

Current Private Credit Sub-Strategy Allocations:

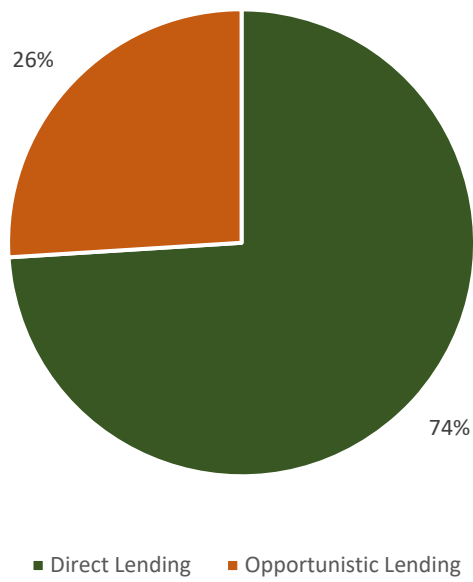
| PC Sub-Strategy | Current Target % | Current Range |
|----------------------|------------------|---------------|
| Direct Lending | 70% | 50% - 100% |
| Opportunistic Credit | 30% | 0% - 50% |
| U.S. | 85% | 75% - 100% |
| Non-U.S. | 15% | 0% - 25% |

Recommended Private Credit Sub-Strategy Allocations:

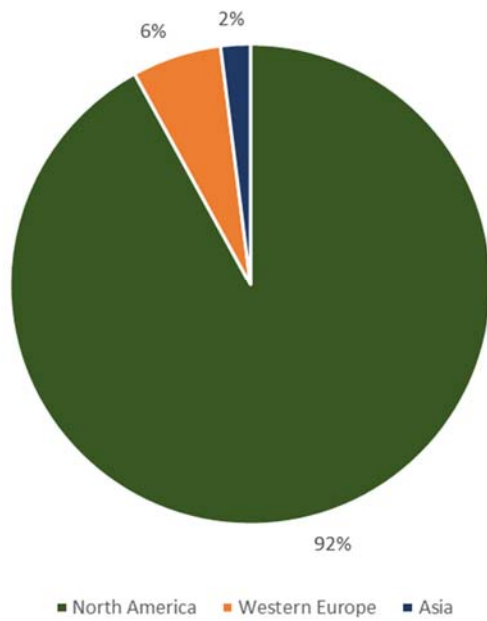
| PC Sub-Strategy | Recommended Target % | Recommended Range |
|-----------------------|----------------------|-------------------|
| Direct Lending | 65% | 50% - 90% |
| Opportunistic Lending | 35% | 10% - 50% |
| U.S. | 75% | 65% - 100% |
| Non-U.S. | 25% | 0% - 35% |

SCERS' current Private Credit exposures by strategy and geography are shown below (as of March 31, 2021):

Private Credit Exposure by Sub-Strategy



Private Credit Exposure by Geography



PRIVATE CREDIT INVESTMENT PLAN

With the increased allocation to Private Credit (4% to 5%), Staff and Cliffwater have revisited the capital budget pacing for Private Credit. Given that the calendar year 2021 is nearly complete, Staff and Cliffwater recommend that SCERS maintain the 2021 Private Credit commitment budget of \$100 million, which was approved by the Board in February 2021. Cliffwater and Staff will come back in early 2022 with an updated 2022 commitment budget and multi-year capital budget model that incorporates the 5% Private Credit target allocation, as part of the 2022 Annual Plan for Private Credit. The Private Credit pacing budgets will lay out the plan to build up toward the 5% target allocation, and maintain that allocation over the long-term.

The budgets incorporate several variables and assumptions, such as plan assets, the growth rate of the plan (SCERS' actuarial rate adjusting for plan cash outflows), capital market assumptions for private credit, and capital drawdown and distribution assumptions for underlying funds). Cliffwater did some preliminary modeling for SCERS using the new target allocation of 5%, and not surprisingly, the annual commitment budgets will increase marginally for 2022 and going forward. The larger commitment budgets are a function of the growth in SCERS' plan assets and the increased 5% target to Private Credit. Cliffwater's capital budget model estimates that SCERS' Private Credit portfolio will reach its 5% target towards the end of 2024, one year later than forecasted in last year's budget.

NEXT STEPS

- Present the 2022 Private Credit Annual Investment Plan in early 2022.
- Incorporate approved Private Credit structure changes into the Growth asset category and Master IPSs.

ATTACHMENTS

- Board Order
- Cliffwater Private Credit Portfolio Structuring Considerations Presentation

Prepared by:

/S/

Steve Davis
Chief Investment Officer

Reviewed by:

/S/

Eric Stern
Chief Executive Officer



Retirement Board Order

Sacramento County Employees' Retirement System

**Before the Board of Retirement
September 15, 2021**

MOTION:

Asset Class Restructuring: Private Credit

THE BOARD OF RETIREMENT hereby accepts the recommendation of staff to approve to approve the implementation plan and make the following revisions to the structure of the Private Credit asset class:

- Establish range of +/- 2% around the new 5% target allocation (3% - 7%).
- Rename the 'Opportunistic Credit' sub-strategy to 'Opportunistic Lending'.
- Adopt new strategy and geographic allocation targets and ranges as identified in the implementation plan.
- Maintain the 2021 Private Credit investment plan until the Board approves an updated commitment pacing budget in early 2022.
- Direct staff to make conforming changes to the Growth Asset Category and Master Investment Policy Statements for approval by the Board at a future meeting.

I HEREBY CERTIFY that the above order was passed and adopted on September 15, 2021 by the following vote of the Board of Retirement, to wit:

AYES:

NOES:

ABSENT:

ABSTAIN:

ALTERNATES (Present but not voting):

Richard B. Fowler II
Board President

Eric Stern
Chief Executive Officer and
Board Secretary

Item 18



Los Angeles • New York

Sacramento County Employees' Retirement System Private Credit Portfolio Structuring Considerations

September 15, 2021

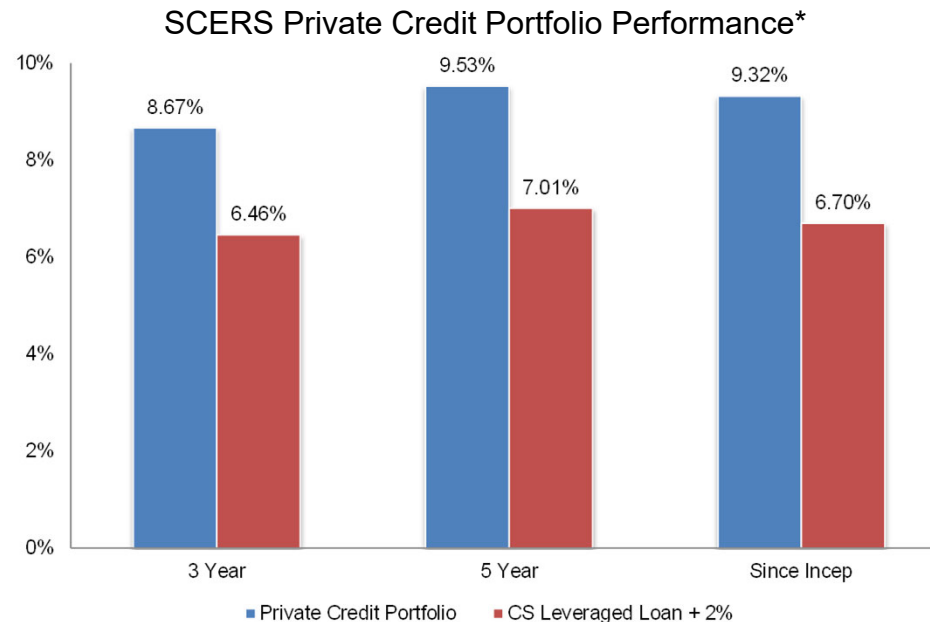
Private Credit Program Objectives

The SCERS Private Credit portfolio is intended to produce attractive risk-adjusted returns and generate current cash flow

- Expect to outperform leveraged loans (large, syndicated bank loans) by 2% annually

The Private Credit portfolio has been meeting its objectives and there are no recommended changes to the stated portfolio objectives

- The recommended changes reflect implementation considerations following the 2021 asset liability modeling study and the continued maturation of the Private Credit asset class



Summary of Private Credit Structuring Recommendations

Adopt a permissible range of 3% to 7% around the new 5% target allocation

- The current Private Credit allocation is 2.0% as of June 30, 2021

Adopt new Private Credit strategy and geographic allocation targets and ranges

- The recommended changes are primarily driven by the continued evolution of the Private Credit market
- Also recommending renaming the “Opportunistic Credit” sub-strategy category to “Opportunistic Lending”
 - Intended to limit confusion with other credit-based strategies

Maintain the current commitment pacing plan for the remainder of 2021

- SCERS has a \$100 million commitment budget target, with an upper limit of \$150 million, in the approved 2021 Annual Plan
- Planning to set the 2022 commitment budget with the upcoming 2022 Annual Plan
- Forecasting SCERS’ Private Credit allocation reaches its new 5% target in 2024
 - That pacing would be one year later than previously forecast for reaching the 4% target

Private Credit Allocation Targets and Ranges

Shown below are the current and recommended targets for the Private Credit strategy, geographic, and total portfolio allocations

| | Current Target % | Recommended Target % | Recommended Range |
|-----------------------|------------------|----------------------|-------------------|
| Direct Lending | 70% | 65% | 50% - 90% |
| Opportunistic Lending | 30% | 35% | 10% - 50% |
| U.S. | 85% | 75% | 65% - 100% |
| Non-U.S. | 15% | 25% | 0% - 35% |
| Total Private Credit | 5%* | 5%* | 3% - 7% |

** The Total Private Credit target allocation was approved with the 2021 asset liability modeling study*

Private Credit Commitment Pacing Recommendations

Cliffwater updated the SCERS Private Credit portfolio allocation forecasts to reflect current portfolio market values and SCERS' new 5% Private Credit target allocation

- Recommend maintaining the current commitment pacing plan for the remainder of 2021
 - The projections assume SCERS commits up to its \$150 million upper limit of the approved 2021 commitment budgets
 - All other assumptions are consistent with the projections included in the 2021 Annual Plan

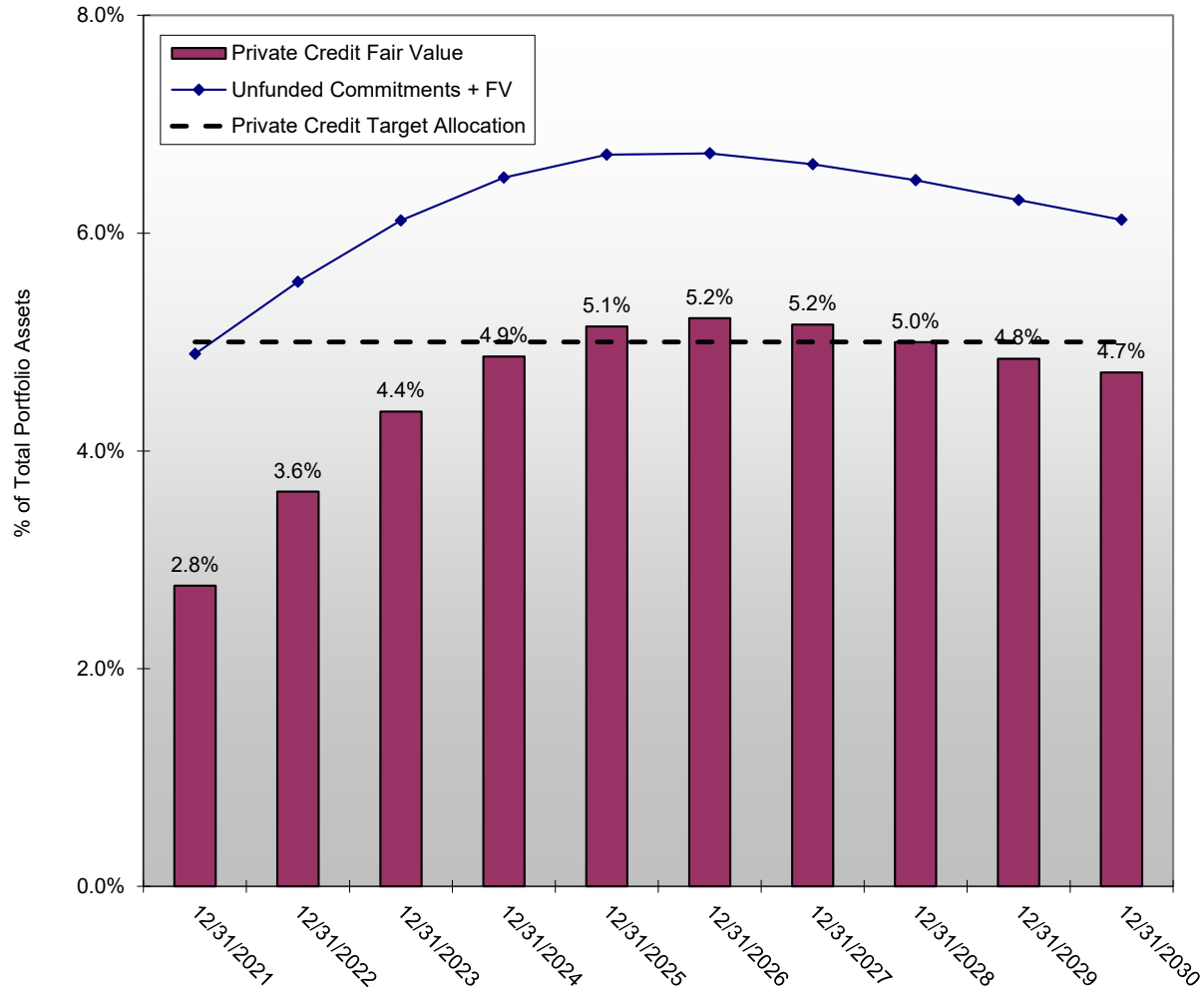
Recommend setting the 2022 commitment budget with the SCERS 2022 Annual Plan

- Currently expect slightly larger budgets in 2022 and beyond, as compared to previous allocation forecasts, given SCERS' fund size growth and the new 5% allocation target

Projecting that SCERS will reach its target allocation towards the end of 2024

- The graph on the following page shows the forecasted Private Credit allocations

Private Credit Allocation Forecasts



Next Steps

Recommend Investment Policy Statement changes

- The recommended Private Credit structure changes go into effect upon Board approval
- The Growth asset category IPS will be revised at a later date
 - The IPS revisions will include Private Credit updates and other Growth asset class updates
 - The Master IPS will also be revised at a later date

Present the 2022 Private Credit Annual Investment Plan in early 2022

- Will include recommended commitment pacing

General Disclosures

This presentation was prepared exclusively for information and discussion purposes, and is not meant to be, nor shall it be construed as, an attempt to define all information that may be material to you. All information including opinions or facts expressed herein are current as of the date appearing in this presentation and is subject to change without notice. All third party information has been obtained from sources believed to be reliable. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of the information or opinions contained in this presentation. Past performance does not guarantee future performance.

This presentation may include sample or pro forma performance. Such information is presented for illustrative purposes only and is based on various assumptions, not all of which are described herein. Such assumptions, data, or projections may have a material impact on the returns shown.

References to market or composite indices (such as the S&P 500), benchmarks or other measures of relative market performance over a specified period of time (each, an “index”) are provided for information only. Reference to an index does not imply that a portfolio will achieve returns, volatility or other results similar to the index. The composition of an index may not reflect the manner in which a portfolio is constructed in relation to expected or achieved returns, portfolio guidelines, restrictions, sectors, correlations, concentrations, volatility or tracking error targets, all of which are subject to change over time.

Hedge Fund Research, Inc. (“HFR”) is the source and owner of the HFR data contained or reflected in this report and all trademarks related thereto.

Frank Russell Company (“FRC”) is the source and owner of the Russell Index data contained or reflected in this material and all trademarks and copyrights related thereto. The Russell Index data may contain confidential information and unauthorized use, disclosure, copying, dissemination or redistribution is strictly prohibited.

Thomson Financial Inc. is the owner and/or licensor of the Cambridge Associates LLC data contained or reflected in this material.

The MSCI information is the exclusive property of MSCI Inc. (“MSCI”) and may not be reproduced or re-disseminated in any form or used to create any financial products or indices without MSCI’s express prior written permission. This information is provided “as is” without any express or implied warranties. In no event shall MSCI or any of its affiliates or information providers have any liability of any kind to any person or entity arising from or related to this information.

Cliffwater is a service mark of Cliffwater LLC.